$50.00 ANNUALLY
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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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Registered with the Securities and Exchange Commission

October 16, 1961 Number 159 Page 1

THE CURRENT PRICE STRUCTURE Following the July (K) lows, both Averages rallied -- Industrials to a new all-time high of 726.53 (August 22), and Rails to point N (144.92 on August 22). Although Industrials thereby established a new primary peak, Rails failed by 6 points to confirm (by bettering their own primary peak of 150.81 -- established on March 22).

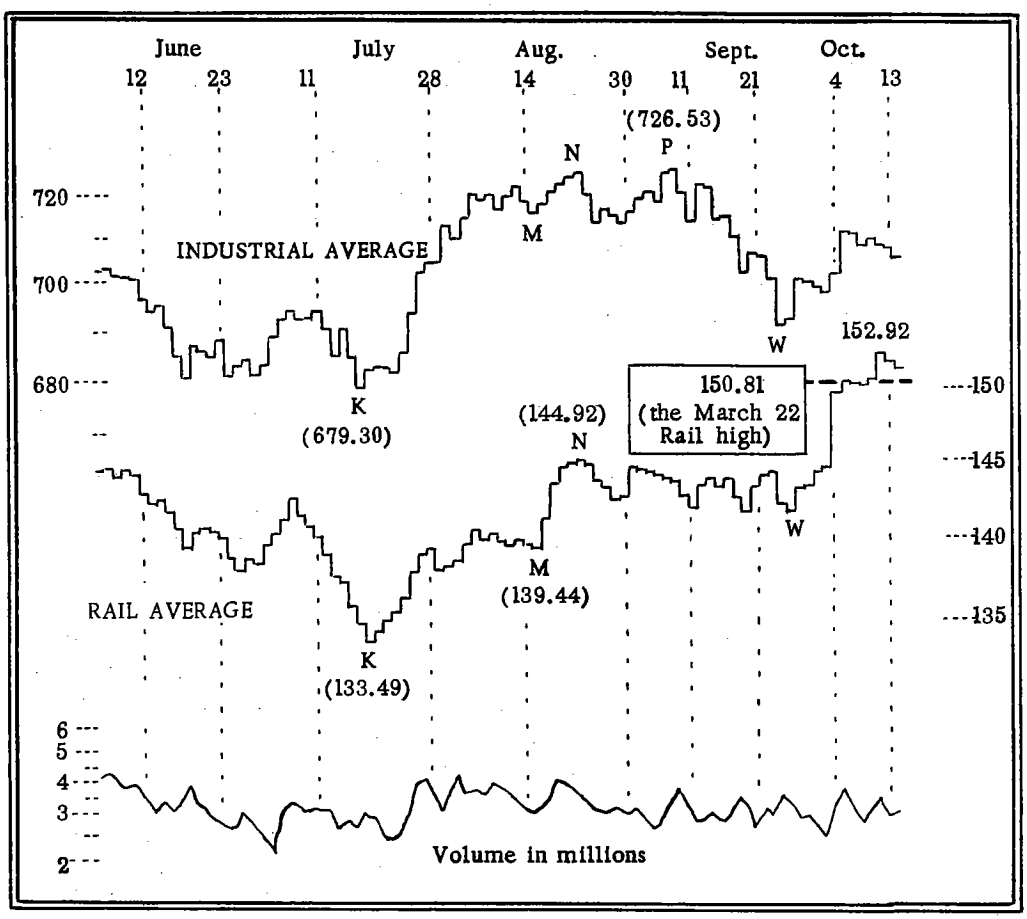
Subsequent to the August high, Industrials broke rather sharply, while Rails held within a narrow trading range. On September 28 a spectacular Rail rally began which, by October 10, succeeded in taking the carrier Average above its March 22 primary peak (150.81). To make matters difficult, the Rail high was recorded with the Industrial Average well below its previous high.

The question now is -- does the October 10 Rail penetration of its previous primary peak (150.81 of March 22) constitute a confirmation of the August Industrial primary high point? Obviously, if we accept the Rail bettering of its own primary peak as a confirmation of the August Industrial high, then we have an all-important reconfirmation of the primary bull trend.

Neither Hamilton nor Rhea placed any time limit on the confirmation principle. The following, in fact, is from one of Rhea's investment Letters written in December, 1932:

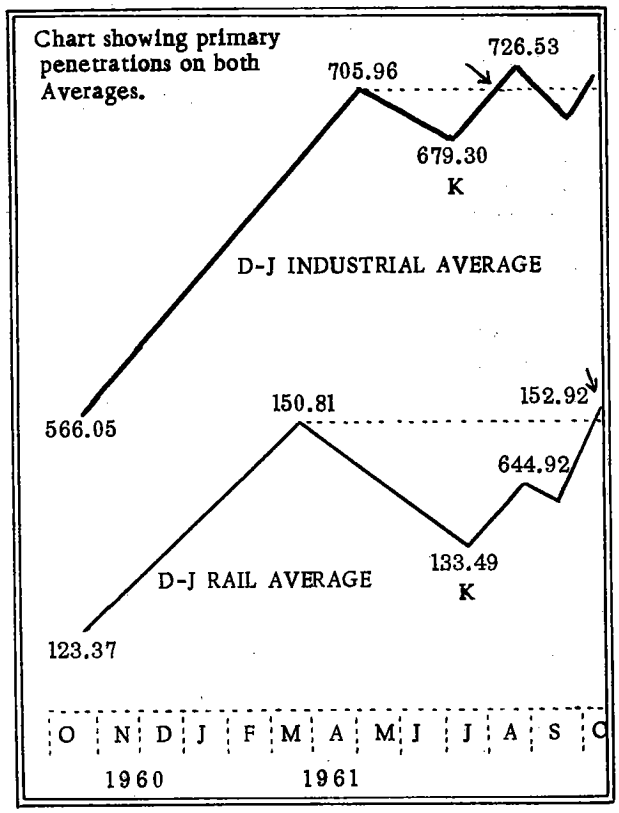
> "Question: The Dow Theory requires that both Averages must confirm penetration of their last high points before a buying signal is given. Suppose one Average penetrates such a high point, later receding below that point, while the second Average establishes a new high. Is there any Dow Theory rule covering such a situation?"

The following is Rhea's answer: "Those who have read Hamilton's complete collection of editorials on Dow Theory will find several such cases discussed. Hamilton believed that if a single Average penetrated to new high ground, then receded, with the other Average subsequently penetrating to new highs, it was proper to take this as a bullish inference, even though the first Average had not recovered its loss. Hamilton did not believe that it was necessary for both Averages to make new highs (or lows) on the same day, or even in the same week or month, but he frequently stated that the signals appeared more valid when the penetration was simultaneous or within a very few days."



From this we can conclude that the recent October 10 bettering of the March 22 Rail high constituted a reconfirmation of the primary bull trend. Since the Rail penetration came seven weeks after the Industrial peak (August 22), however, we cannot call the reconfirmation an impressive one (as would have been

 the case if the two penetrations had been simultaneous or at least a few days apart).



Under Dow Theory, when both Averages rise above preceding primary peaks (as is now the case), the significance of all preceding low points is erased. For this reason, neither the July lows or any other lows are now of importance. If weakness is to appear, then new decline points will be established, and it will be these future decline lows which we will use as the significant downside levels in the price structure.

Because of the series of downward zig-zags in both Averages following P on Industrials and N on Rails, Letters 157 and 158 classified the secondary trend as bearish (with the primary trend, of course, continuing bullish). I had drawn attention to the importance of the M level on Rails, and throughout the decline Rails never did penetrate M. This fact casts doubt on my own conclusion in Letters 157 and 158 regarding the secondary trend, and I now believe that I should have classified the secondary trend as obscure -- rather than bearish.

Because the Rails steadfastly resisted penetrating the M point on the downside, and in view of the fact that last week the carriers rose above their preceding primary peak (150.81), I now believe it is proper to call the secondary (and primary) trends bullish. Final verification of this will require an Industrial bettering of its all-time high at P (726.53).

Conclusion: The secondary trend will be classified as bullish (despite Industrial weakness) as long as Rails hold above M (139.44). The primary trend continues bullish.

Near-term: Last week saw another period of divergence with Rails surging higher or holding and Industrials hesitating or declining. Over the near-term the question is -- will Industrials follow the spectacular lead of the Rails or will Rails be dragged down by the Industrials? If Industrials can get "in gear" with Rails on the upside, and if a forthcoming rally succeeds in taking the senior Average above P (726.53), it is my guess that we could see some explosive advancing action in both Averages. Such action could easily broaden out to include the rest of the stocks on both the New York and American Exchanges. From the bullish standpoint, it is a hopeful sign that volume has contracted noticably whenever the market has declined.

NOTES: A clue which might explain some of the recent violent Rail action is the fact that the carrier Average has now broken out of the great triangle pattern which has been forming since 1956 (see Letter 156 -- extra copies on request -- please send stamped self addressed envelope). The Rail average has also broken above its long descending relative strength line which has been in effect since 1959 (see Letter 158).

On October 12 the 5-day moving average of "new highs' touched 63, which equals (but does not surpass) the best performance seen so far on the rally since July (see Letter 158).

PASSING THOUGHTS At the time when this writer's first article appeared in Barron's (December, 1958), the "technical approach" to the market was a novelty on Wall Street and literally unknown to the general public. In the three years since then, a veritable army of "technicians" has sprung up. Indeed, a few new investment services (perhaps hoping to find the rainbow's end) are now attempting to reduce the technical "indicators" to some sort of all-inclusive "market divining rod". "When the majority of 'important technical tools' point up," we are told, "then the market must go up", etc.

At the risk of being labeled a kill-joy, let me venture to say that it never was and never will be that easy. Nobody has yet invented a system for "beating the market". Moreover, when too many cooks get into any market pudding, then unexplicably, the pudding refuses to jell. Most recently I have heard that Merrill, Lynch is going to attack the market problem with the aid of giant computers. All of which reminds me of the cartoon which shows a young stock market student standing in front of a huge maze of IBM equipment. He has just fed a mountain of market statistics into the mechanism, and he appears crestfallen as he studies the card which has just emerged from the machine. It reads: "Buy low -- sell high."

FOREIGN MARKETS: All primary and most important secondary market movements tend to be international in scope. "When America sneezes", runs the old adage, "Europe catches a cold." With the balance of economic power swinging towards Europe, the adage could now easily be reversed. Because of the important inter-relationship of the economies of the Free World, these Letters have offered periodic reviews of the major world markets (see Letter 148).

In general, the profiles of 7 European markets show faltering movements, but nothing which yet implies liquidation of the true bear market variety. The Italian market, having suffered a drastic collapse in 1960, has now recovered the better part of its loss (but it has not yet hurdled the 1960 high).

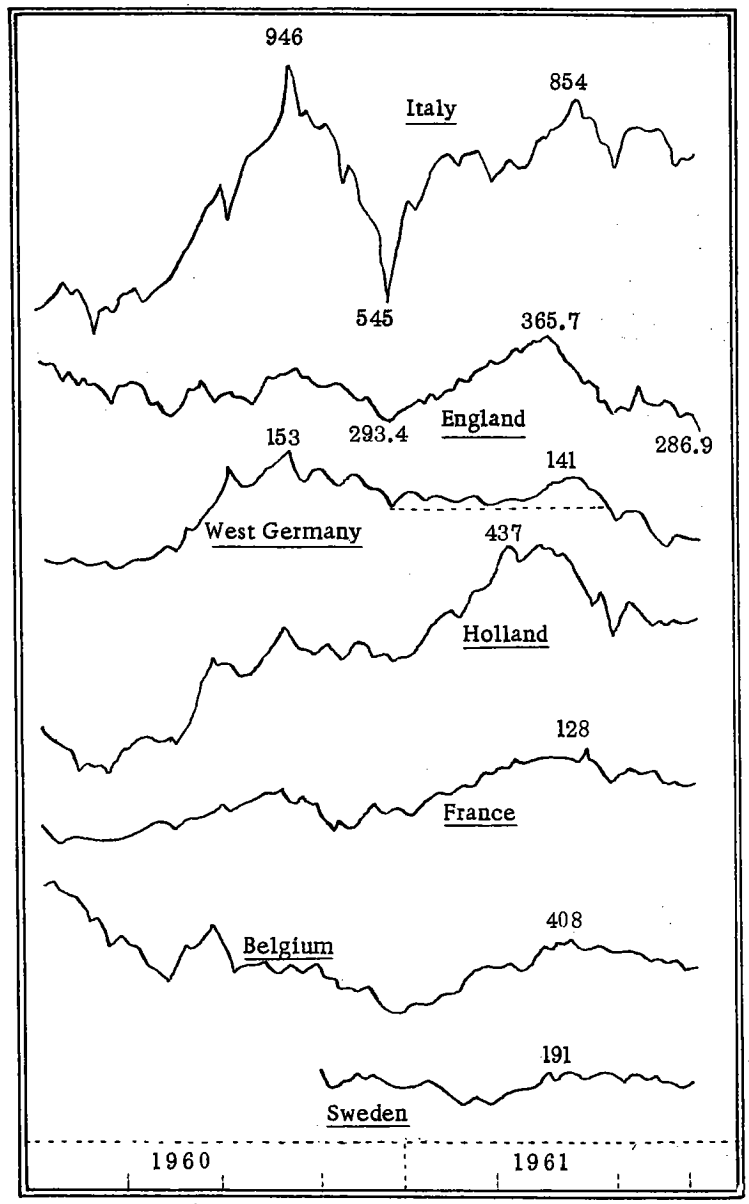
England continues to put on an outstandingly poor performance. Subsequent to the 365 high of early 1961, the English market (last week)dropped through the 293 low of 1960. So far, the penetration has not set off heavy selling.

West Germany presents one of the worst market profiles of any in the Free World. Having failed to better the 153 peak of 1960, the German market has recently broken the low recorded in late 1960. This movement has the appearance (at least on this single average) of a bear signal.

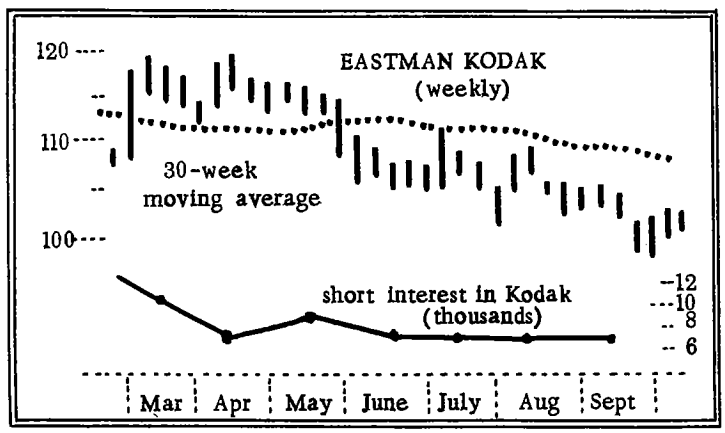
Holland is well down from its 437 high of early 1961, but is still holding above the 1961 low. France shows a gentle "rolling over" action suggestive of a secondary reaction.

Belgium has obviously not recovered from its earlier political troubles, and the 408 peak of 1961 is well below the earlier 1960 high. Sweden seems to be in a long "line", with evident investor apathy regarding the possibilities in either direction.

If there is trouble ahead it is my guess that it will appear in the form of heavy liquidation in either the English or West German stock markets.



STOCKS There are a few points regarding the current action of individual stocks which probably have a bearing on the general market. Many stocks, such as Eastman Kodak, Alcoa, International Harvestor, etc., which have obviously "broken down" through important support, have, nevertheless, not declined in a manner suggestive of bear market action. For instance, the chart of Kodak (EK) shows the stock violating its long-term or 30-week moving average (M. A.) in May of this year. The penetration came at about 112. Five months have elapsed since EK turned bearish, and although EK has been a sluggish performer and has tended to drift steadily lower, it has still not "fallen apart" as might have been expected. In a major bear market, following the initial May downward penetration, we could expect EK to have been "cut in half" by now.

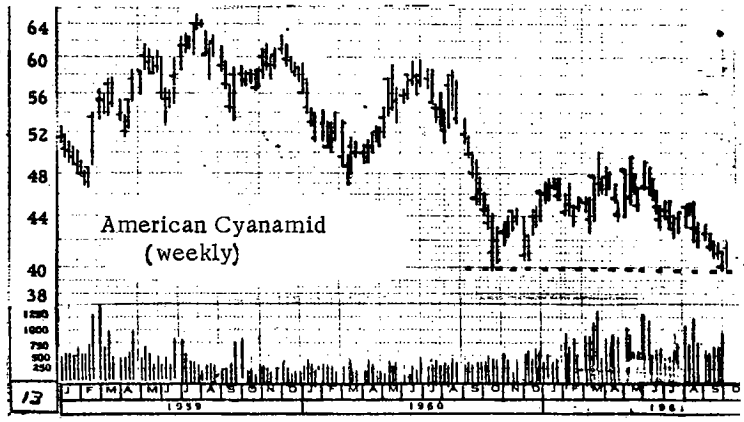


In examining the weekly and daily charts of some 350 stocks, I have noticed this same tendency. The chief exceptions have been some of the airlines, many of the electronics (which have suffered severe collapses) and a few sundry stocks such as Royal Dutch, J. I. Case and Standard Packaging.

In a good many stocks, the advance since late 1960 has been subject to full corrections. In other instances, almost the entire 1960-61 advance has been wiped out. The chart of American Cyanimid is an example of the latter, and here we see ACY returning to the same base at 40 from which the 1960 advance began.

This presents an interesting problem in tactics; namely, is it better to buy a stock which is obviously "breaking out" into new

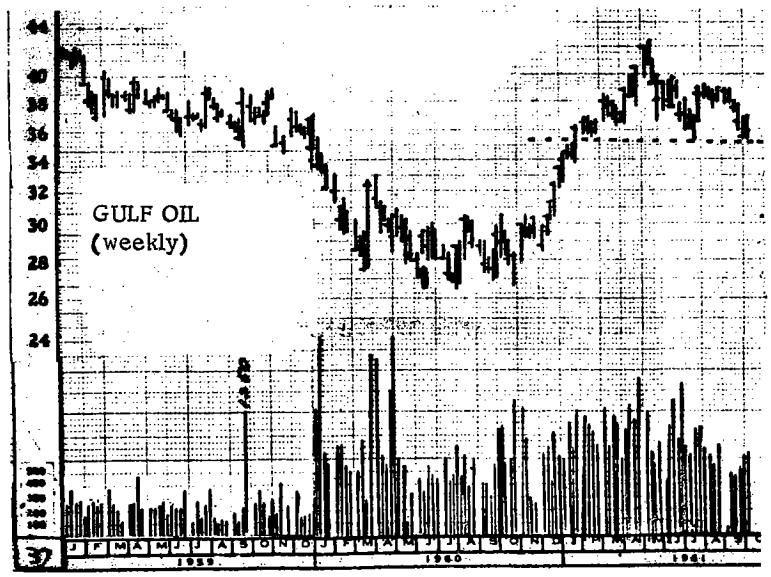
high territory such as Sears or Southern Pacific or is it better to try to pick a stock off its bottom as we did with General Electric and as we are trying to do with Outboard Marine and Westinghouse.



The answer is that it depends on the psychological make-up of the trader. Those who need "action" and don't mind jumping out with a two point loss (if the stock reverses) should buy the obvious "breakouts". An example of this was Avco which was recommended last year at 17 1/2 and which worked out very well. For those who are more concerned with safety and minimizing downside risk, the preferable procedure is to buy stocks (such as Westinghouse and perhaps even Cyanimid) in the hopes that the lows have been seen and that a substantial move is ahead. In the case of Cyanimid, (1) a "stop-loss should be placed at about 38 1/2, (2) possibly a great deal of patience will be needed before an upward move gets started. Two things are known: (1) the stock is of fairly good quality, (2) Cyanimid has lost better than 1/3 of its value since the 1959 high. Only time will tell whether the 40 area is merely a temporary support level or whether 40 represents the extreme low for the current decline.

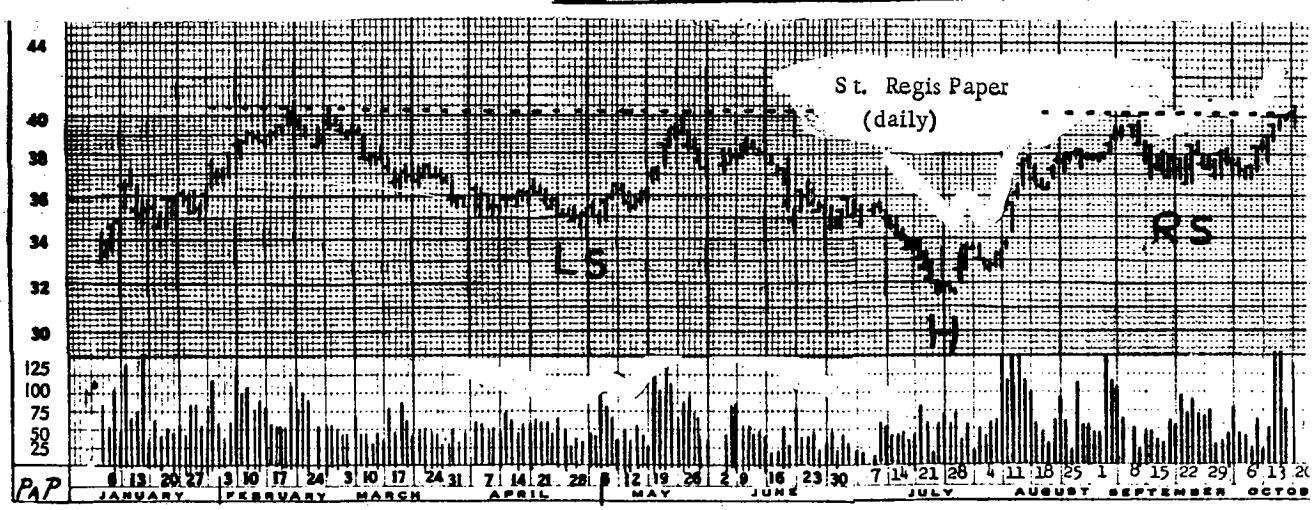
Eight of the seventeen stocks in the "continuous study" group are under their long-term 30-week moving average (no change from last week). General Electric has regained almost half the loss sustained on the drop from its 1959 high of 99 7/8 to its 1961 low of 60. A bettering of 80 (the halfway point) will suggest that GE is in line for an approach to the old high. (Current moving-average on GE is 67). Goodyear recently decline to "test" its M. A. (which is now 41 3/4), then rallied toward the high again. I list GT as in a continuing bull trend. New York Central is still trying to get started. On the recent rally CN could not move substantially above its earlier peak of 19. There is a good deal of "supply" (a polite word for the holdings of "locked-in-investors") in the 19 to 21 area, and if CN can gradually work through this, it may yet be a stock (M. A. is now 18). Note on International Paper -- the stock has now turned strongly bullish, and has moved above all peaks for the year (should be a "buy" on any decline).

Back in Letter 144 I drew attention to the bullish pattern of St. Regis Paper. The stock has been consolidating and has now formed an impressive inverse "head-and-shoulders" base. The daily chart below shows SRT touching the 40 level three times, and recently returning again to this level. The chart suggests that the accumulation phase is about complete, and a break out of the "right shoulder" (RS) formation above 40 should market the beginning of a good rise. Buy on a volume breakout above 40.



Not so fortunate is Gulf Oil, and the weekly chart shows a "toppy" formation with a critical level at 35. I believe the stock can be shorted on any rally, with probabilities favoring lower prices in the months ahead.

Written Monday, October 16, 10 A.M.



Charts of SRT and GO courtesy of Traders Research. P.O. Box 6185, Lambert Airport, Mo.